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RURAL CREDIT POLICY:
DO WE NEED TO TARGET?

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PREFACE

This publication is prepared under a collaborative research project concerning rural finance in the Philippines. The principal collaborating institutions are the Philippine Institute for Development Studies (PIDS), the Agricultural Credit Policy Council (ACPC), and the International Rice Research Institute (IRRI). OSU participation is funded by the USAID Mission in the Philippines and the Bureau of Science and Technology, AID, Washington. The views expressed in these publications are those of the authors and may not be shared by any of the collaborating or sponsoring institutions. In particular, the views in this paper are those of the author and should not be attributed to the ACPC.

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GILBERTO M. LLANTO*

The prominence given to credit targeting as a critical approach to increase the productivity and well-being of specific sectors of the economy is exemplified by a recent proposal in the Philippines to establish a "tobacco planters' bank" in order "to help tobacco farmers in their financing needs." The proposal draws strength from the traditional view that credit is a vital component of a strategy to increase output and enhance the welfare of economic agents involved and must, therefore, be directed or channeled to a particular

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purpose or sector, i.e. targeted[1/] and, if possible, given at concessionary rates.

Proponents of this view argue that credit targeting will bring about a higher level of productivity in the rural sector because cheap agricultural credit to pre-identified groups and/or specific commodities will encourage farmers to use modern inputs, avail themselves of modern technology and make productive investments. The ultimate pay-off will come in terms of increased output, expansion of the growth potential of the rural economy and, more importantly, an increase in farmers' incomes.

This credit philosophy is also thought capable of offsetting the penalty impact on the rural sector of macroeconomic policies like overvalued exchange rates, price controls and taxes on agricultural output. These policies introduce distortions in factor and goods markets and create adverse efficiency and equity effects. One way, therefore, to try to offset this negative impact is through credit targeting.

Such is the popular view.

This article argues that (a) loan or credit targeting does not work, (b) the government, which has no comparative advantage in the lending business, should stay out of it, and (c) the government should, however, create the appropriate economic and

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1/ This paper assumes that credit targeting invariably requires payment of concessionary interest rates by borrowers. Credit targeting and subsidized credit, therefore, are used interchangeably in this paper.

financial environment to induce greater bank lending to the rural economy.

This paper is divided into five (5) sections: Section 1 gives a brief review of the Philippine experience with loan targeting; Section 2 describes the present orientation of rural credit policy; Section 3 discusses recent developments in rural financial markets, and Section 4 deals with a systems approach to the problem of raising rural output and farmers' incomes. Section 5 provides concluding observations.

I

The Philippine Experience with Credit Targeting

The Philippine experience with credit targeting gives some interesting lessons in terms of the effect of cheap credit on agricultural output, farmer incomes and resource mobilization in the rural areas. There are also some spill-over effects of the massive infusion of cheap credit on domestic liquidity and the balance of payments.

Targeted loans became relatively more pronounced and substantial in 1973 with the advent of the government's rice self-sufficiency program popularly known as Masagana-99. Cheap credit was combined with fertilizer subsidies and extension services to attain self-sufficiency in rice and generate an exportable surplus.

Using about 6,000 technicians, millions of pesos, huge fertilizer subsidies, price supports and irrigation, M-99 was the most ambitious production program ever implemented in the Philippines (Sacay, Agabin and Tanchoco, 1985). The food targets were attained. For the period 1973-1979, the additional output of palay was 5.3 million metric tons equivalent in volume to about 3.2 million metric tons of rice[2/] (TBAC, 1981).

However, the program's cost to the government was staggering. For the 1973-1980 crop year, Sacay, et. al. (1985) estimated the total cost borne by the government to be as much as ₱2.1 billion (Table 1).

While the rice production target may have been achieved, if not exceeded by a large margin, still the program has to be reexamined in the light of attendant costs. In particular, there seems to be some evidence that the credit subsidy had a low pay off and that the production goals would have been achieved anyway even in the absence of a massive infusion of cheap credit (Sacay et. al. 1985). On the other hand, there is also some evidence that the fertilizer subsidy, the extension services and the availability of modern technology would have sufficed for the attainment of the food production target.

If the credit subsidy had a low pay off, then it makes no sense to extend cheap credit which becomes a budgetary problem for the government. It is better under such circumstances to

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2/ The reported success of the M-99 was disputed by Herdt and Gonzalez (1981) who argued that the 5.3 percent growth in rice production during the period of M-99 was not significantly different from the growth rate observed prior to the program.

Table 1. Estimated Cost of Masagana 99, Crop Year 1973-1980

Item	Amount (Million Pesos)	Percent of Total
Credit Subsidy	903	43.6
Market Price Subsidy	733	35.4
Fertilizer Subsidy	366	17.7
Extension Services	69	3.3
Total	2,071	100.0

Source: Sacay, Agabin and Tanchoco (1985) spend the money for fertilizer, extension services and technology transfer.

On the other hand, a cheap credit policy could yield unintended results. One of the unintended results was the estimated incidence of the subsidies granted through this program. Esguerra (1981) showed that the subsidies were largely captured by formal lenders and not by the intended target group, the farmer borrowers. Other evidence pointed to benefits accruing to the supply dealers, rice traders and consumers with the notable exception of farmer-borrowers (Sacay et. al. 1985). The equity impact of subsidized credit programs, therefore, is less than desirable. Neri and Llanto (1985) found that low-income farmers who availed themselves of 73 percent of the total number of loans, enjoyed only 32 percent of the total amount of subsidized loans granted. On the other hand, the high income farmers who accounted for 27 percent of the total number of subsidized loans granted, took 68 percent of the total amount of subsidized loans granted. In effect, there was a real income transfer to high income farmers from small income farmers.

The credit subsidy did not reach the intended borrowers - the small farmers - and thus, "it will still be the more viable and bigger farmers who will gain access to it and retain credit lines" (Lamberte and Lim, 1987). Loans represent claims on resources and this access to cheap credit gives the bigger farmers additional command over resources. Since cheap money winds up in their hands, subsidies become very concentrated (Gonzales-Vega, 1977), and this worsens rural income distribution.

The government used the supervised credit scheme to promote the M-99 program and the other supervised credit programs which mushroomed thereafter. Under this scheme, low-interest and collateral-free loans for production were channeled through the rural banks and the Philippine National Bank. The loanable funds were obtained from special time deposits of the government and through the rediscount window of the Central Bank of the Philippines. The encouragement of the government and the natural instinct for making profits out of cheap money induced a wide usage of these funds by rural banks.

These sources of funds created serious and negative spillover effects on the development of rural financial markets. The convenient access to cheap money inhibited real financial intermediation in the rural economy. Savings mobilization was neglected as rural banks obtained more than half of their loanable funds from special time deposits and rediscounts with the Central Bank of the Philippines (Neri and Llanto, 1985). There was no determined effort to mobilize savings because rediscount money was cheap money. The rural banks in effect became mere channels of government credit, and there were limited opportunities to perform real banking functions, such as diversification of portfolios, spreading of risk, and financial intermediation.

Since loan portfolios were not judiciously managed, many rural banks eventually found themselves saddled with high arrearages. Tolentino (1987a) noted the rapid deterioration of the quality of loan portfolios. Prior to the M-99 program, past due loans were only about 11 percent of the rural banking system's loan portfolio. By 1984 this proportion had increased to one-third. Rural banks' arrearages to the Central Bank of the Philippines increased to 72 percent in 1984 from 28 percent in 1972. This weakened the formal rural financial system and further hampered the growth of the rural financial markets.

On the part of farmer-borrowers, loan targeting caused an excess demand for the cheap institutional credit. The result was credit rationing as banks became very selective in granting loans. Thus, only the bigger farmers who were bankable and had collateral and other assets, were able to take advantage of the cheap institutional credit. This "crowding out effect" drove small farmers to the informal credit markets, the only available source of credit for them.

Thus, loan targeting, subsidized credit and credit quotas sponsored by government brought perverse effects. Lending to specified target groups did not allow the diversification of risks and denied credit to non-farm enterprises (Meyer, 1979). The growth of rural financial markets lagged behind (Floro, 1987) while the equity objective was waylaid.[3/]

A little-mentioned although equally important aspect of cheap credit funded through the rediscounting window of the Central Bank concerns its implications for domestic monetary expansion and the balance of payments. Liberal rediscounting causes domestic monetary expansion. Maximizing economic agents respond by disposing of excess cash balances and shifting towards holding more real assets and foreign money. This creates tremendous pressure against the stock of international reserves (Llanto, 1987). The experience in Costa Rica, El Salvador and Nicaragua in the 1950s showed that liberal rediscounting of agricultural loan paper caused corresponding foreign exchange reserve movements (Takagi, 1986).

In support of special credit programs like M-99 the Central Bank of the Philippines allowed rediscounting of numerous agricultural loan papers (Table 2). This had an immediate impact on domestic liquidity. The ratio of outstanding redis-

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3/ It is instructive to note that similar credit programs in other developing countries have also failed. Osuntogun and Oludimu (1981) observed that for over forty years, the government of Nigeria has been making efforts to provide credit facilities to small and medium-scale farmers. Such efforts have not been able to meet more than a tiny percentage of the credit requirements of the peasant farmers.

counts to domestic liquidity averaged 9 percent from 1949-1972. But when special credit programs mushroomed during the period 1973-1982, the average ratio of outstanding rediscounts went up to 13 percent, an increase of 44.4 percent over the average of the previously-cited period (Lamberte and Lim, 1987). This contributed in an important manner to the excess liquidity problem of the country during the early part of the 1980s and correspondingly to balance of payments pressure.

II.

Present Orientation of Philippine Rural Credit Policy

Financial reforms were introduced in the recent period (1980-1987) to arrest the decline of the rural financial system (see Meyer, 1987; Tolentino, 1987; Graham, 1987). A uniform and market-oriented rediscount rate was adopted in place of the selective and subsidized credit policy. This is part of the deregulation of the financial system which removed lending and deposit interest rate ceilings and phased out the issuance of Central Bank bills. More recently, a rehabilitation package for rural banks was announced by the Monetary Board of the Central Bank of the Philippines, and a Comprehensive Agricultural Loan Fund (CALF) was created by Executive Order 113 which merged seventeen out of the thirty-nine separate commodity loan funds.

The rehabilitation program avoids the writing off and liquidation-approach but instead presents an opportunity to ailing rural banks to reschedule their outstanding indebtedness with the Central Bank of the Philippines and to strengthen their capital base by infusing fresh private capital. The most noteworthy feature of the program is the infusion of new additional private capital which is the "ticket" for joining the program. This represents a form of commitment by the rural banks' stockholders to rationalize banking operations and management. A rural bank which has "bought the ticket" could either (a) opt for an equity conversion of its supervised rediscount fund arrearages and work out a repayment plan with the Central Bank of the Philippines/Land Bank of the Philippines, as the case may be, or (b) enter into a plan of payment directly with the Central Bank on an equal monthly amortization schedule. (See Graham, 1987 and CB Circular 1143 dated April 24, 1987, for details). The participants in the rehabilitation program would then be allowed access to the rediscount window.

The creation of the CALF consolidated the different special credit programs of the Department of Agriculture into a single fund which was converted into a guarantee fund. It indicates the government's realization of the futility of targeting credit to specific commodities/end-users and engaging in direct lending activities. Under the guarantee scheme, a maximum of 85 percent of the default risks of bank lending to agricultural projects is assumed by the CALF. It is expected that this risk-sharing strategy will attract private banks to lend to agricultural projects. Government from then on will not be involved in the lending business which is the area of comparative advantage of financial institutions.

The CALF guarantee is operated through the three existing guarantee facilities of the government: (a) the Philippine Crop Insurance Corporation (PCIC), (b) the Quedan Guarantee Fund Board (QGFB) and (c) the Guarantee Fund for Small and Medium Enterprises (GFSME).

The PCIC provides insurance coverage for rice and corn which can perhaps be expanded later on to include certain vegetables. The QGFB operates the quedan system of guarantees for loans based on warehouse receipts or quedans of grain stocks. Traders and millers borrow from banks on the basis of these quedans. The GFSME extends guarantee cover for agricultural loans made by commercial and private development banks.

In sum, the present rural credit policy relies on the market to bring about the efficient allocation of resources in the countryside. It recognizes that government has no comparative advantage in managing credit programs. The economy's goal of attaining increased rural output and farmer income is better served by creating an economic and financial environment that provides the rural sector enhanced opportunity to develop and participate in the fruits of development.[4/]

4/ Section 4 discusses the point more fully.

III

Recent Developments in Rural Financial Markets in the Philippines

We discuss here only three of the recent welcome developments in rural financial markets: (a) emphasis on rural resource mobilization, (b) attempts to link informal productive groups with banks and (c) moves to develop a secondary market system for agricultural loan papers.

Rural Resource Mobilization

Savings mobilization in the rural areas has today gained a respectable endorsement from policymakers and bankers alike. The traditional assumption that the rural areas cannot save and will, therefore, not be induced to save is now being challenged. Rural banks that lost the cheap rediscount facility have now realized that to stay in business they will have to perform real financial intermediation, and mobilizing deposits has no substitute in building a loanable fund base.

The Agricultural Credit Policy Council is at the forefront of the campaign to mobilize rural savings through its Rural Savings Mobilization Project, a joint action-research project undertaken with the Ohio State University. This project will identify the different savings modalities in the rural areas, determine the significant factors in rural household saving, and recommend the appropriate policy response.

This study will complement the effort to rehabilitate the rural banking system. The rehabilitation will produce a more efficient and dynamic rural banking system which will not act as a mere conduit of government funds but will, among others, intermediate financial resources in the rural areas.

Linking Informal Self-Help Groups with Banks

The rationalization of rural credit policy has triggered some concern over the fate of small farmer-borrowers who are perceived to be generally unbankable. This mode of thinking believes that without loan targeting and concessionary interest rate these small farmer-borrowers do not stand a chance vis-a-vis the loan applicants with collateral, proven record and managerial expertise.

The fear is unfounded. The present market-orientation of rural credit policy has been introduced so that factor prices will reflect their true scarcity value which leads to their more efficient utilization. Together with this orientation is a totally new perception of the agricultural sector generally and farming in particular. The new perception considers agricultural activities as a legitimate economic and business activity and not simply as a source of inexpensive food for urban consumers and cheap raw materials for domestic industry and export. In the past, the goal was increased production. Today it is growth in production and profitability to farmers.

To make farming profitable the government has pursued reforms in several fronts: the dismantling of the sugar and coconut monopolies, removal of export taxes on agricultural products except logs, liberalizing fertilizer importation, lifting the copra export ban and reducing the role of the National Food Authority in wheat, flour and other feed imports (Meyer, 1987). Certainly, there are other areas of reform but the first decisive steps have been undertaken.

On another front, the current effort to improve access to banking services of the informal sector can not be underestimated. In the rural areas various self-help groups (SHGs) which are informal, grassroots organizations, have been formed to address group-specific problems. The SHGs include many small farmers as their members; they are engaged in productive economic activities and perform regular lending and saving functions for their members. Their loan fund is generated from the deposit mobilization efforts of members and other internally generated resources.

The promotion of linkages between banking institutions and SHGs will improve the access of small farmers and the low-income groups to banking services. In the Philippines, this promotion of linkages is spearheaded by the Philippine Council for Rural Savings and Finance (PCRSF), an umbrella non-government organization organized in October 1986 to promote savings-based financial system via self-help groups in the rural financial market, with the assistance of the Agricultural Credit Policy Council through technical and consultation services.[5/]

5/ See Gilberto M. Llanto, "Report on the Asia and Pacific Regional Agricultural Credit Association Regional Experts Consultation on the Survey of Self-Help Groups", Agricultural Credit Policy Council August 4, 1987.

Two of the many possible linkage models are shown in Figures 1 and 2. The linkages will encourage savings mobilization among members of SHGs because these resources can be utilized by them as some sort of guarantee fund against which they can borrow from banks. Previously, non-bankable farmers who save and pool their savings for deposit in the banks will now be able to avail themselves of institutional resources. In short, the savings of SHGs will constitute the collateral and/or credit guarantees needed by banks.

In the direct linkage model (Figure 1), the SHG coordinates with government agencies (like the Land Bank of the Philippines), with non-governmental organizations (NGOs) for technical services and assistance, and with donor agencies also for seed fund purposes, and mobilizes members' savings for deposit in the banks. The SHG obtains credit which it can on-lend to its members. The group savings become a collateral and/or guarantee fund.

The indirect linkage model (Figure 2) differs only with the earlier model because of the presence of a self-help promotion institution (like the PCRSF) which acts as the direct link of member-SHGs with the government agencies, NGOs and donors on the one hand and with the banks, on the other hand[6/]. This institution acts as a broker for SHGs. The legal personality and status of the self-help promotion institution enables it to deal with

6/ Other models were presented in the Experts Consultation Meeting on Self-help Groups, Jogjakarta, Indonesia, July 28-30, 1987.

institutions like banks which may require legal personality as a pre-condition for doing business with an entity.

Towards a Secondary Market for Agri Loan Papers

The Guarantee Fund for Small and Medium Enterprises (GFSME) is currently proposing the design and implementation of a secondary market system (SMS) for short, medium and long-term agricultural loans originated under the Guarantee Fund for Small and Medium Enterprises (GFSME), Quedan Guarantee Fund Board (QGFB), and the Philippine Crop Insurance Corporation (PCIC). This is a response to the shift in the government's rural credit policy from direct, subsidized lending to a guarantee-type of operation. The SMS will allow the trading of agricultural loan portfolios among banks and other financial institutions. The liquidation of the loan portfolios carried by the three guarantee institutions will create the liquidity needed by the rural sector, and allow savers and investors to position funds advantageously. It will encourage investors to maximize the purchase of agricultural loan papers because they would not be "locked in" since they can at anytime change the composition of their asset portfolios. Risk can be minimized by using the CALF as "buyer of last resort", especially during periods of tight liquidity. This strengthens investor confidence and the viability of the SMS.

The government's participation in the SMS through the CALF in providing guarantee cover and acting as "buyer of last resort" will increase farm credit with out going to direct lending programs which strain the budget.

On the other hand, the commercial banks who are willing to lend to agriculture, but hesitate to do so because of perceived liquidity and interest rate risks (Llanto, 1986), would find the SMS a convenient outlet of excess bank liquidity. Rural penetration and coverage of the rural banking system is unparalleled (Tolentino, 1987b) while commercial banks are currently awash with investible funds. It is here where the SMS would matter when commercial banks buy agricultural loan papers which are originated by rural banks and provided guarantee cover by CALF. Rural banks can concentrate on the retail side of rural lending in view of their familiarity with the various nuances of agricultural lending; commercial banks and the guarantee institutions can play the secondary market.

IV

A Systems Approach to Rural Development

The new orientation of rural credit policy takes the position that credit, much less targeted or subsidized credit, is not the critical element in raising farm input and farmer income. There is some consensus about this proposition. In fact, some authors believe that the cheapness of institutional credit is of little interest to the borrowers - much more important is the economic opportunity associated with the use of some extra capital (Adera, 1987)and that the critical elements are those that will reduce prices of fertilizer and other inputs, and raise producer prices (Tolentino, 1987b)

Credit therefore is only an instrument whose effectiveness depends on the economic and financial policies and programs that go with it. Supply-leading finance does not necessarily bring about increased productivity and greater farmer welfare, although certainly in its subsidized form excess demand for it arises. On the contrary, there is ample evidence that farmers respond positively to realistic farm-gate prices while competitive prices of fertilizer, seeds and other inputs increase efficiency in production and brings higher net returns to farming.

The systems approach views the problem of rural development as a general equilibrium problem where everything "hangs together". It recognizes the complexity of interaction and interface between and among technology, resources, infrastructure, markets and other support systems, information and attitude. Viewing the components of this package in isolation only leads to "waste, inefficiencies and confusion" (Padmanabhan, 1982).

In this respect the Department of Agriculture maintains that the best way to assure the economy of food sufficiency, increased rural output and inflow of foreign exchange from agricultural exports is to make agriculture profitable. But to make it profitable means making a system approach operational in agri culture. Credit is easy to dispense; it does not take too much imagination and, above all, it can be used to further some political aims. Making credit count and exposing its true nature and function is a more difficult undertaking. Fortunately, the Department of Agriculture assigns it a secondary role in attaining the agricultural sector's growth and equity objectives.

V

Conclusion

The present orientation of rural credit policy brings a new era to Philippine rural finance. The experiment with loan targeting and subsidized credit was costly; its accomplishments with respect to the desired goal of increasing rural output and raising farmer income is open to question.

The present rural credit policy is complemented by recent developments in rural financial markets. But most important of all is the growing realization and consensus that the problem of rural development is a general equilibrium problem and is better addressed by a systems approach.

Table 2

Agricultural Credit Programs Funded through the Rediscount Window

Program	Year Implemented	Rediscount Rate	Prescribed Lending Rate
Masagana-99	1973	3.0% (of w/c 2% is rebatable[a/])	not exceeding 12%[d/]
Cotton Financing Program	1974	1.0%[b/]	not exceeding 12%[d/]
CB-MECS Supervised Experienced Education Program	1974	1.0%[b/]	not exceeding 12%[d/]
Gulayan sa Kalusugan	1975	1.0%[b/]	not exceeding 12%[d/]
Bakahang Barangay			
a. Fattening	1978	1.0%[b/]	10.0% + 2 service charge [e/]
b. Cow/Calf	1981	3.0% [c/]	12.0%[f/]
Biyayang Dagat	1979	1.0%[b/]	10.0% + 3.0% service charge[g/]
Orchard Crops	1982	3.0%[c/]	15.0%[h/]
Maisagana	1982	3.0%[c/]	15.0%[h/]
Pukyutang Barangay	1982	3.0%[c/]	15.0%[h/]
Kalabaw ng Barangay	1983	3.0%[c/]	15.0%[h/]

a/ Later decreased to 1.0% in May 1974 (MCRB 74-24), then increased to 3.0% in February 1981 (CB Circular No. 784), then pegged to the Manila Reference Rate in March 1984 (CB Circular No. 994).

b/ Later increased to 3.0% in February 1981 (CB Circ. No. 784), then pegged to the MRR in March 1984 (CB Circ. No. 994).

c/ Later pegged to the MRR in March 1984 (CB Circ. No. 994).

d/ Later specified to be 10% basic rate and 2% service charge in January 1977 (MCRRBSSLA 77-4), then 10% basic rate and 3% service charge in May 1978 (CB Circ. No. 610), then 12% inclusive of service charge in September 1980 (CB Circ. No. 750), then 15% inclusive of 3% service charge in May 1982 (CB Circ. No. 930) then pegged to the MRR in March 1984 (CB Circ. No. 994) and eventually lifted in November 1985 (CB Circ. 1086)

e/ Later, service charge increased to 3% in May 1978 (CB Circ. No. 610), then 12% inclusive of service charge in September 1980 (CB Circ. No. 750), then 15% inclusive of 3% service charge in May 1982 (CB Circ. No. 930), then pegged to the MRR in March 1984 (CB Circ. No. 994), and eventually lifted in November 1985 (CB Circ. No. 1986).

f/ Later, increased to 15% in May 1982 (CB Circ. No. 930), then pegged to the MRR in March 1984 (CB Circ. No. 994), and eventually lifted in November 1985 (CB Circ. 1086).

g/ Later decreased to 12.0% in September 1980 (CB Circ. No. 750), then increased to 15% in May 1982 (CB Circ. No. 930), then pegged to the MRR in March 1984 (CB Circ. 994), and eventually lifted in November 1985 (CB Circ. No. 1086).

h/ Later, pegged to the MRR in March 1984 (CB Circ. 994), and eventually lifted in November 1985 (CB Circ. 1086).

Source: Various CB Circulators

Figure 1

DIRECT LINKAGE MODEL

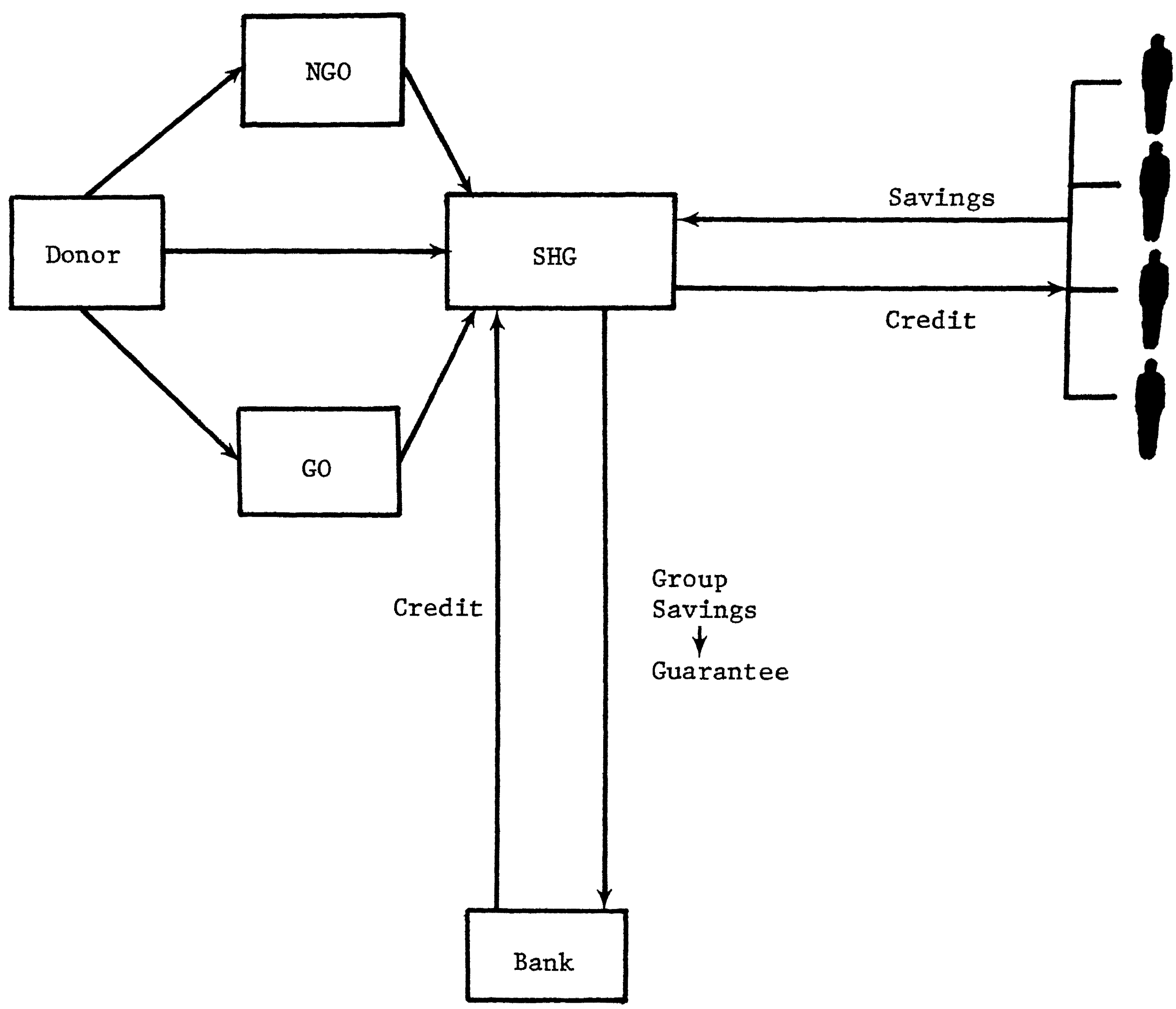
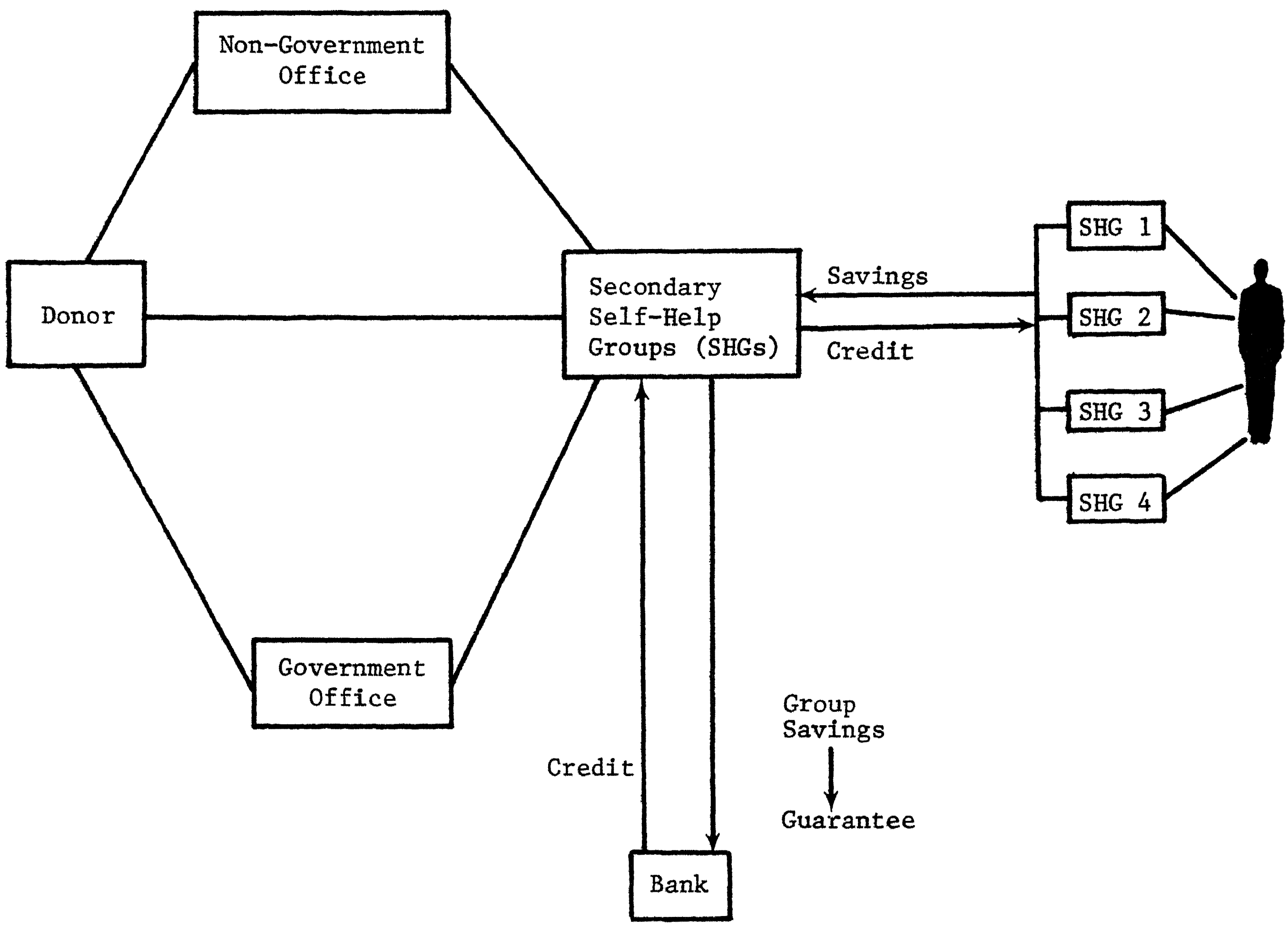


Figure 2

INDIRECT LINKAGE MODEL



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